Franchise Tax Board

# REVISED ANALYSIS

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|---|---|---|---|---|---|
| Author: | Wyland | Analyst: | Jeff Garnier | Bill Number: | AB 2328 |
| Related Bills: | See Prior Analysis | Telephone: | 845-5322 | Amended Date: | April 1, 2004 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT:** S Corporations/Carryforward of Net Operating Loss (NOL) and Tax Credits/Conformity /Accrual Method

X REVENUE ESTIMATE CHANGED.

____ FURTHER CONCERNS IDENTIFIED.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED __________ STILL APPLIES.

____ OTHER – See comments below.

## SUMMARY OF BILL

This bill would provide limited tax relief for corporations required in 2002 to be "S" corporations for state purposes. In addition, this bill would conform to the current federal accrual method of accounting rules.

## SUMMARY OF REVISION

The revenue impact presented in the prior analysis of the bill as amended April 1, 2004, omitted the "Limitation on Use of Non-Accrual Experience Method of Accounting" provision of the bill. The revenue impact presented in this analysis supercedes the prior revenue estimate. There are no other revisions being made to the prior analysis.

## POSITION

Pending.

| Board Position: | | | Legislative Director | Date |
|---|---|---|---|---|
| ____ S | ____ NA | ____ NP | | |
| ____ SA | ____ O | ____ NAR | Brian Putler | 3/19/04 |
| ____ N | ____ OUA | X PENDING | | |

**ECONOMIC IMPACT**

Revenue Estimate

Projected revenue losses are as follows (assumes enactment after 6/30/04):

| Fiscal Year | 2004-2005 | 2005-2006 | 2006-2007 |
|---|---|---|---|
| Elimination of Built-in Gains (BIG) Tax | Losses not exceeding $1.5 million | Losses not exceeding $500,000 | Losses not exceeding $500,000 |
| Exempt corporations from the last in-first out (LIFO) recapture tax | Losses not exceeding $1 million | Losses not exceeding $300,000 | |
| NOL Carryover from C Corp to S Corp and shareholders | Losses not exceeding $600,000 | $1.2 million loss | $1.2 million loss |
| Credit Carryover from C Corp to S Corp | Losses not exceeding $500,000 | Losses not exceeding $250,000 | Losses not exceeding $250,000 |
| Limitation of Non-Accrual Experience Method Accounting | Gains not exceeding $4.5 million | Minor gains | Minor gains |
| TOTALS (order of magnitude) | $1 million gain | $2.2 million loss | $2.0 million loss |

Revenue Discussion

Since a corporation can postpone the sale of assets beyond the 10-year recognition period so as not to become subject to the built-in gains tax, it is not possible to determine the number of corporations that will become subject to the BIG tax as a result of the mandatory conversion to an "S" corporation. Currently only 0.3% of all "S" corporations report BIG tax with an average BIG tax liability of approximately $26,000. This equates to approximately $294,000 of built-in gains per corporation.

For purposes of this analysis, it is assumed that the BIG issue would affect approximately 1,300 "S" corporations. If 1% would be subject to the BIG tax annually over the next 10 years, this would impact less than 15 corporations each year. Assuming an average BIG tax of $26,000 and average built-in gains of $294,000, the elimination of the BIG tax would result in minor (under $500,000) revenue losses annually. The first fiscal year 2004-05 includes three years of revenue losses.

Based on available data, the total LIFO recapture tax is not expected to exceed an average of $300,000 annually. The first fiscal year 2004-05 includes four years of revenue losses.

NOL carryover from "C" corporations to "S" corporations and shareholders -- Based on available data, it is estimated that the utilization of NOL carryovers from the "C" corporation to the "S" corporation is expected to result in a revenue loss of approximately $1.2 million annually over a period of five years.

Credit carryover from "C" corporations to "S" corporations -- Available information indicates that most tax credits are applied in the current year, resulting in a negligible carryover balance. Therefore, allowing 100% of the carryover credits from the "C" corporation to be used by the "S" corporation is expected to result in negligible revenue losses, less than $250,000 annually. The first fiscal year 2004-05 includes two years of revenue losses

Limitation on the use of non-accrual experience method of accounting -- The estimate for conformity to the federal limitation on use of non-accrual experience method of accounting is based on federal projections for that provision. The 2004-05 impact for the state conformity includes the first two years of the federal projection since the provision would be effective January 1, 2003.

**LEGISLATIVE STAFF CONTACT**

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